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INTRODUCTION

In accordance with the City Auditor's 1993-94 Audit Workplan, we have audited the city of San Jose Workers' Compensation Program. We conducted this audit in accordance with generally accepted government auditing standards and limited our work to those areas specified in the Scope and Methodology section of this report.

The City Auditor's Office thanks the Risk Management Unit, specifically the Risk Manager, the Workers' Compensation Manager, and the entire staff in the Workers' Compensation Section of the Risk Management Unit who gave their time, information, insight, and cooperation for this audit.

SCOPE AND METHODOLOGY

This is the second of three audit reports on the city of San Jose (City) Workers' Compensation Program (Program). This report focuses on estimating the outstanding liability, while the third report will address cost containment methods for the Program. Our methodology included interviews with City personnel in the Workers' Compensation Section, Finance Department, Accounting Section, Office of Management and Budget, Department of Human Resources, and the Police Department and meetings with the City's external auditors and actuaries. In addition, we

- Conducted interviews with industry experts;
- Surveyed other jurisdictions;
- Reviewed claims listings;
- Analyzed summary and detail data reports;
- Reviewed actuarial reports;
- Assessed internal policies and procedures for compliance with state requirements;
- Reviewed applicable Governmental Accounting Standards Board statements;
- Assessed the adequacy of reserves;
- Evaluated the validity of City information and assumptions provided to the actuary;
- Evaluated payroll rates for appropriateness, accuracy, and the capability to pay current and future claims liabilities;
- Analyzed whether claims are over- or under-reserved;
- Determined whether unauthorized payments on claims were made; and
- Performed a statistical sample of individual claims in the workers' compensation claims database.

In July 1991, the Program acquired a computer system with a claims management database. The statistical sample mentioned above was performed to test the integrity and accuracy of information in the claims database and to analyze the efficiency and effectiveness of claims management.

BACKGROUND

Department Mission

The mission of the Finance Department in administering the Workers' Compensation Program (Program) within its Risk Management Unit is *"to operate a self-insured program providing State-mandated benefits to City employees for work-related injuries and illnesses more economically than is possible through a State-insured program."*

In addition, the specific goals of the Risk Management Unit are

TO serve both the public and the City organization by identifying risks and minimizing or transferring those risks in order to protect the assets of the City and to preserve the well-being of citizens and City employees.

TO uniformly provide Workers' Compensation Benefits in accordance with the State of California Labor Code and in conjunction with the Memorandums of Agreement as well as other applicable City policies and procedures. These benefits are to be provided while exercising fairness in working with all parties in a timely, cost-effective, and professional manner.

Department Organization

The Program is administered by the Risk Management Unit of the Finance Department. Chart I shows the organization of the unit as of September 1992. It should be noted that as of September 1993 the Program has lost two positions--one staff technician and one senior account clerk.

Chart I

A new management team has been put into place over the past few years. The Risk Manager position had been vacant for nearly two years when it was filled in July 1992. The Workers' Compensation Manager position was vacant for almost one and a half years before it was filled in June 1991. In addition, the Director of Finance position was vacant during the same period.

History

California first dealt with the problem of uncompensated work injuries in 1911 by adopting the Roseberry Act, which provided employers a voluntary plan of compensation benefits. It was superseded in 1913 by the Boynton Act, which made these benefits compulsory. This enactment, as amended and codified, is the one in force today. Since the enactment, California workers have been entitled to medical treatment and compensation payments for industrial injuries. According to Jeffrey V. Nackley's Primer On Workers' Compensation,

> *Workers' compensation is considered a beneficial system and remedial in character. Accordingly, it is liberally construed in favor of the intended beneficiaries. Liberal construction does not mean that courts are free to deviate from plainly stated legislation but it does mean that ambiguities in statutes will be resolved in favor of coverage and that otherwise valid claims will not be denied on the basis of technicalities.*

Employers within the workers' compensation system must comply with workers' compensation law by either obtaining insurance or, where permitted, insuring themselves. All employers are required to abide by the workers' compensation laws of the state of California and must follow the pronouncements of the Workers' Compensation Appeals Board (WCAB) in rating permanent disability claims and handling disputed claims. All permanent disability awards must be approved by the WCAB. There are three options available to employers

seeking workers' compensation coverage: state fund insurance, private insurance, and self-insurance.

The Five Major Benefits

The California Workers' Compensation Act provides for five major benefits.

1. *Medical Care* - The injured employee is eligible for all reasonable medical care necessary to cure or treat an injury.

2. *Temporary Disability* (TD) - The injured worker is also entitled to a TD benefit, which is the wage loss benefit payable during absence from work authorized by a medical practitioner.

3. *Permanent Disability* (PD) - The injured employee may also be entitled to a PD benefit, which is a benefit predicated on the reduction of the worker's ability to compete for a job in the open market.

4. *Vocational Rehabilitation* (Voc Rehab) - Should the worker be unable to return to his/her employment, he/she may be entitled to Voc Rehab benefits which include continued payment of any necessary medical expenses, vocational training under an approved plan, payment of maintenance allowances (Voc Rehab TD) while training, and additional living expenses necessitated by the plan.

5. *Death Benefit* - Should death ensue as a result of an injury that is found to be compensable under the compensation laws, the deceased's family may be entitled to death benefits and burial expenses.

Types Of Claims

There are four types of claims. They are information-only, medical-only, indemnity, and death.

Information-Only Claims

Information-only claims are filed to document an injury or illness when an employee does not plan to seek medical attention (e.g., when an employee suspects work-related exposure to communicable diseases, toxic substances, or smoke from fires). The purpose of filing a claim is to document the incident in case disease or injury develops at a later date that could be related. No costs are incurred by either the city of San Jose (City), as the employer, or the employee, and no reserve amount is required.

Medical-Only Claims

Medical-only claims are filed for work-related injuries or illnesses for which lost time does not exceed three days; the City, as the employer, pays all costs of medical treatment. The City assigns a beginning reserve amount of $2,000 to all medical-only claims.

Indemnity Claims

Indemnity claims are filed for a work-related injury or illness which normally results in loss of time from work. The employee is compensated for lost time and all medical costs of the injury or illness. The two major types of indemnity claims are TD and PD. Current workers' compensation law provides for a maximum of $336 per week for TD and a maximum of $140 per week for PD.

- Temporary Disability. Employees with work-related illnesses or injuries receive a state-mandated TD amount of $336 maximum per week. In the City, negotiated memorandums of agreement provide additional compensation in the form of a disability leave of absence or disability leave supplement (DLS) when employees are on TD. Sworn personnel receive TD of $336 per week and DLS to equal 100 percent of their regular salary, while non-sworn receive benefits equal to 85 percent of their salary. TD and DLS are paid out of departments'

personal services budgets, not by the Workers' Compensation Fund. Adjusters reserve for the ultimate estimated cost of these claims including TD, but not including DLS.

- Permanent Disability. Most kinds of compensation available in workers' compensation systems are attempts to compensate for loss of either earnings or earning capacity and are usually paid or accrued weekly. The basis for an award of compensation is the worker's earnings at the time of injury or death and the fact that it was work-related, not the nature or location of the injury or the manner of inception of the disease. Compensation for PD is based on the state of California's Schedule For Rating Permanent Disabilities. The schedule rates a disability based on such factors as the claimant's age, occupation, and extent of injury to evaluate his or her ability to compete in the open labor market.

Death Benefit Claims

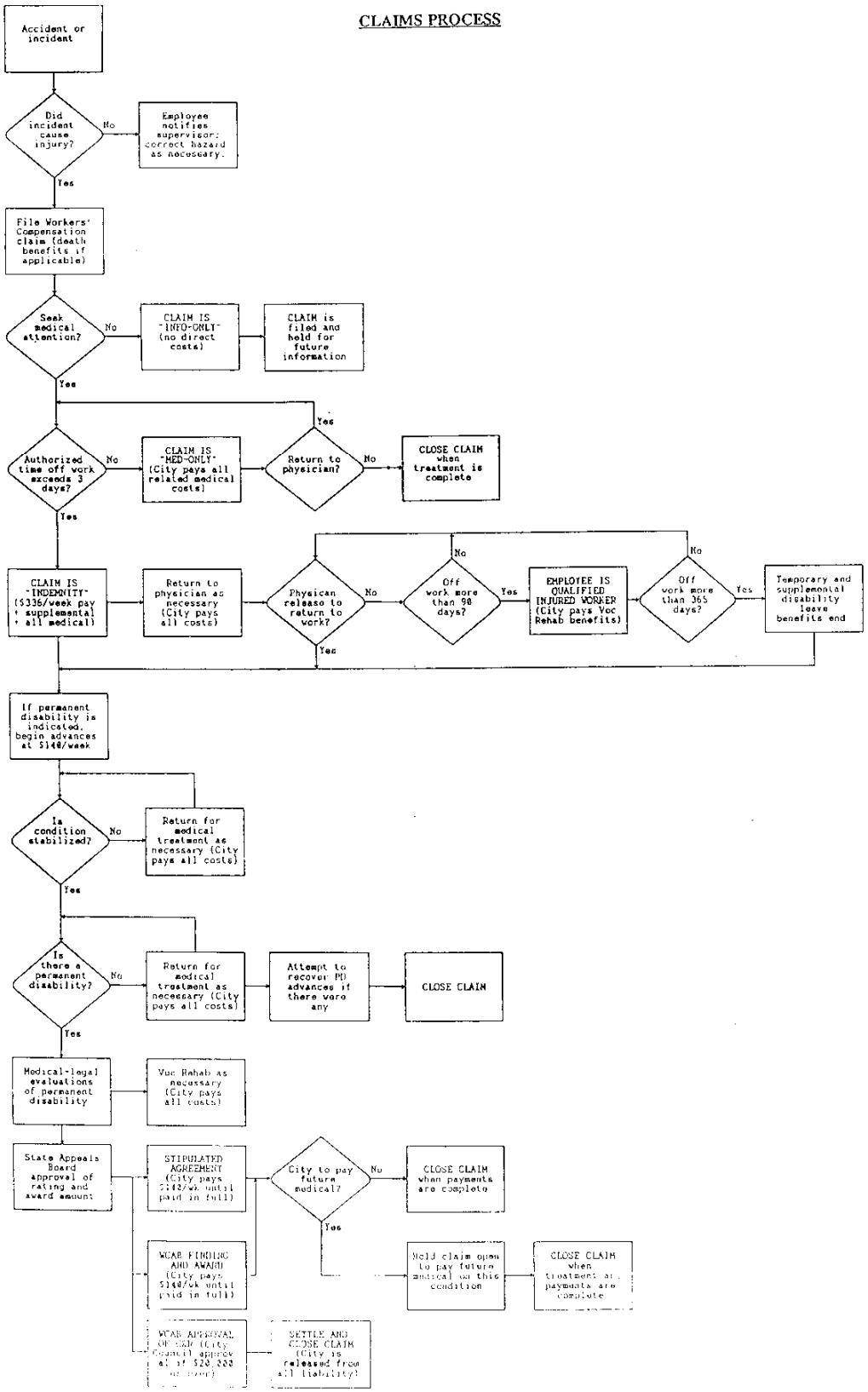
Death benefits in workers' compensation claims include burial expenses and support for the dependent survivors of the deceased employee. In addition, any payments for either temporary or total disability due and unpaid at the time of death are paid to the dependents. Adjusters establish a reserve amount for future payments of the death benefit.

Medical-only and indemnity claims are the most frequently reported types of claims and comprise about 50 percent each of the total number of claims in any one year. In 1992-93, 1,604 claims were reported: 791 were medical-only, and 813 were indemnity claims. Total number of claims reported in 1992-93 is down 131 from the 1,735 claims reported in 1991-92.

Chart II shows the claims process.

CHART II

CLAIMS PROCESS



Claims Management

In 1991, the Program acquired a claims data management system that aids the adjusters in managing their caseloads and minimizing penalties. The stand-alone, computerized David System, designed by the David Corporation, with Release 5.1 of CompPlus software, came on line in July 1991. The system tracks the status of claims, produces management reports, and generates workers' compensation payments.

The Office of Benefit Assistance and Enforcement (OBAE), Audit and Enforcement Unit, conducts targeted and random audits of self-insurers. OBAE publishes a Schedule of Penalties listing the nature of the claims administration violations for which penalties from $25 to $5,000 may be assessed. Two examples of violations are (1) missing or incomplete file records ($100 penalty) and (2) failure of a claims administrator to provide a claim form within 24 hours upon request of an injured worker or his/her agent ($5,000 penalty).

Revenue

Funding for the City's Workers' Compensation Fund comes from four sources: (1) reimbursements from City funds, (2) investment interest earnings, (3) reimbursement from the State Compensation Insurance Fund, and (4) subrogation recovery. Revenues from the State Compensation Insurance Fund and subrogation recovery are extremely difficult to estimate as they are very unpredictable from year to year. Table I summarizes recent fund activity.

TABLE I

WORKERS' COMPENSATION FUND ACTIVITY
FROM 1986-87 THROUGH 1992-93 (In Millions)

	1986-87 Actual	1987-88 Actual	1988-89 Actual	1989-90 Actual	1990-91 Actual	1991-92 Actual	1992-93 Actual
REVENUES							
Reimbursement from City funds	$11.5	$ 9.5	$ 7.9	$ 7.9	$ 7.7	$ 9.6	$ 9.8
Interest	2.2	2.5	3.0	2.6	2.2	1.8	1.7
Received from other sources	0.3	0.2	0.1	0.8	0.5	0.2	0.1
TOTAL REVENUES	$14.0	$12.2	$11.0	$11.3	$10.4	$11.6	$11.6
EXPENSES							
Operating expenses	$0.8	$0.8	$ 0.8	$1.5	$1.5	$ 1.5	$ 1.7
Payment of claims	5.9	5.0	5.9	8.0	8.4	10.3	10.2
Net adjustment to accrued liability[1]	14.5	7.0	(19.0)	(2.0)	0.3	5.9	7.0
TOTAL EXPENSES	21.2	12.8	(12.3)	7.5	10.2	17.7	18.9
TRANSFER IN (OUT)[2]	(2.0)	(2.2)	0.0	0.0	(4.9)	5.7	0.0
NET INCOME (LOSS)	$(9.2)	$(2.8)	$23.3	$3.8	$(4.7)	$(0.4)	$ (7.3)

Reimbursement From City Funds

The primary income stream for the Workers' Compensation Fund comes directly from each department's personal service budget and is based on payroll rates calculated for employees in five categories: police, fire, clerical, manual, and

[1] In the financial statements, "adjustments to the accrued liability" appear in the "payment of claims" line.

[2] Interfund transfers are listed separately from revenues and expenses in the financial statements. The effect of a transfer is a change in retained earnings which, in turn, affects Fund equity. A "transfer out" will decrease retained earnings. A "transfer in" will increase retained earnings.

According to the Finance Department, of the $4.9 million that was transferred out of the Workers' Compensation Fund in 1990-91, $1 million was transferred to the General Fund and $3.9 million was transferred to the General Liability Fund. Then in 1991-92, the City transferred $5.7 million from the General Liability Fund into the Workers' Compensation Fund.

non-manual. At year-end 1992-93, reimbursement from City funds was estimated to be $9.8 million.

Interest Earnings

Investment interest earnings are the main external source of revenue for the Workers' Compensation Fund. As of June 30, 1993, cash reserves for outstanding claims totaled approximately $32 million. These funds are invested with the City's pooled investments. For 1992-93, interest earnings were estimated at $1.7 million.

Reimbursement From The State

As a result of City participation in the State Compensation Insurance Fund prior to July 1974, the City continues to receive revenues in the form of reimbursements for pre-1974 claims that remain open. As of June 30, 1993, there were only four such open claims. In addition, if an employee with a pre-1974 claim was re-injured in later years and that injury is deemed to be related to the pre-1974 injury, that may also be a reimbursable claim. As deaths, retirements, and closed cases occur over the years, the payout from the State Compensation Insurance Fund has become less and less and is not predictable.

Subrogation

When an industrial injury is caused by the negligence or intentionally wrongful act of some person other than the employer, the injured employee has two rights (causes of action): (1) the right to workers' compensation benefits and (2) the right to sue the wrongdoer for damages in a court action. However, these rights are governed so as to give the employee only the greater of the two recoveries. The damage suit is called a "third-party action." The City, as employer, also has a right to sue the wrongdoer for damages which consist of any

compensation payments made to the employee. In this respect, the employer is said to be "subrogated" to the rights of the employee whom it insures. The number of third-party actions that will occur in a fiscal year is unpredictable as is the total of their potential settlement awards. Therefore, revenues from this source are also difficult to estimate.

Major Accomplishments Relating To The Program

In Appendix B, Program management informs us of accomplishments related to the Program. According to Program management, it has

- Implemented a claims management database system as of July 1991;
- Achieved salary savings in claims administration through elimination of all contract workers as of October 1991;
- Enhanced and corrected claims computer data through several major efforts;
- Revised reserving policies and implemented guidelines for staff; and
- Implemented a cost containment program in October 1993.

Furthermore, Program management has informed us that it is

- Increasing efforts in the safety education process by developing training programs customized to reduce specific injury trends and
- Evaluating the use of an individual portfolio of investment funds for the Workers' Compensation Fund.

Appendix B contains the full text of the memorandum.

FINDING I

THE CITY COULD HAVE REDUCED ITS FINANCIAL STATEMENT LIABILITY FOR WORKERS' COMPENSATION BY $4.6 MILLION OVER AND ABOVE THE $4 MILLION PREVIOUSLY IDENTIFIED AS OF JUNE 30, 1993

In 1974, the city of San Jose (City) withdrew from the state of California Workers' Compensation Program and began to self-insure its own workers' compensation program. As such, the City is responsible for paying all of the workers' compensation claims its employees file and attendant administrative expenses. Once an employee files a workers' compensation claim, the City's policy essentially requires the City to estimate the total amount the City will have to pay over the life of the claim and to "fully fund," or set aside, a reserve of cash equivalent to that amount plus related expenses. Our audit of the City's Workers' Compensation Program (Program) revealed the following:

- The City's preliminary estimate of Program liability as of June 30, 1993, was approximately $10.9 million more than the Workers' Compensation Fund's (Fund) cash reserves. As such, the City's fully funded policy was not being followed. The Administration has proposed a multi-year program to address this situation;

- The City's Program liability as of June 30, 1993, was based upon an actuarial study that was conducted in accordance with an internal City policy that is outdated and unauthoritative;

- Recent and future actuarial studies to determine the City's Program liability have been and will be hampered by a lack of sufficient claims history information;

- Subsequent events reduced the City's Program liability as of June 30, 1993, by $4 million;

- Our survey of other California cities revealed that several rely on their own workers' compensation claims databases to estimate their workers' compensation liabilities;

- San Jose's average claims liability is in line with other California cities;

- Over the last three years, the City has developed a computerized database for workers' compensation claims that is now reliable and accurate enough to satisfy Governmental Accounting Standards Board requirements. This new capability obviates the need for an actuarial study to estimate the City's Program liability;

- Reliance on the information in the Program claims database and early implementation of a Governmental Accounting Standards Board pronouncement could have reduced the City's financial statement liability by an additional $4.6 million as of June 30, 1993; and

- Administrative and auditing procedures are needed to maintain the integrity of the claims database.

Accordingly, the City could have reduced by $4.6 million both the City's June 30, 1993, financial statement liability and the amount that the City Council will need to appropriate between now and June 30, 1999, to fully fund the Program.

San Jose Is Self-Insured For Workers' Compensation

Prior to July 1974, the City participated in the State Compensation Insurance Fund. On June 20, 1974, the City Council passed Ordinance No. 17284 which created and established the Workers' Compensation Fund and provided for the deposit and expenditure of monies therein. On July 1, 1974, the City began its self-insured workers' compensation program. Self-insured employers are required to pay their workers the same benefits as workers would receive under the state

fund or private insurance. The City has never purchased excess insurance and has administered its own workers' compensation claims from the beginning.

According to the Department of Industrial Relations, Self-Insurance Plans Division, there are three standards that a company must meet to qualify as a self-insurer of workers' compensation in California. They are:

- Financial strength to pay normal and catastrophic workers' compensation losses;
- Competent administration of the benefit delivery system; and
- An effective safety and health/accident prevention program.

The City has held its self-insurance certificate continuously since 1974.

The City Has A Policy To "Fully Fund" Its Workers' Compensation Fund Claims Liability

Once an employee files a workers' compensation claim for a work-related illness or injury, a Program adjuster estimates the total expected cost of the claim. On an annual basis, the City recognizes the outstanding liability for workers' compensation claims on its financial statements. According to a 1981 Personnel Department policy,

> *The City of San Jose shall maintain a fully reserved Workers' Compensation Trust Fund in the same manner as the law requires of non-public agency self-insured employers and of Workers' Compensation insurance companies. To ensure the solvency of the Workers' Compensation Trust Fund, claim reserves shall be established by reviewing all disability claims that remain open more than six months on an individual basis to determine what costs are likely to result during the life of the claim. Reserve amounts for all open claims will be individually reviewed and revised on at least an annual basis.*

The City accounts for its Program in an internal service fund. This is the recommended accounting treatment. The state of California does not require the

City to fully fund its workers' compensation liability. However, the Fund will show a deficit balance if there are insufficient assets for full funding.

Table II shows that the workers' compensation liability has been fully funded for the past several years and summarizes the percentage of the liability which has been funded. Table II also demonstrates that preliminary estimates indicate a less than fully funded liability for 1992-93.

TABLE II

COMPARISON OF BALANCE SHEET STATUS
OF WORKERS' COMPENSATION FUND
JUNE 30, 1987, THROUGH JUNE 30, 1993 (In Millions)

	6/30/87 Actual	6/30/88 Actual	6/30/89 Actual	6/30/90 Actual	6/30/91 Actual	6/30/92 Actual	6/30/93 Actuals
ASSETS							
Cash	$29.2	$34.1	$38.6	$31.7	$27.4	$32.2	$31.9
Other	1.6	0.9	0.7	0.8	1.0	1.0	1.0
TOTAL ASSETS	$30.8	$35.0	$39.3	$32.5	$28.4	$33.2	$32.9
LIABILITIES							
Liability for self-insurance	**$40.0**	**$47.0**	**$28.0**	**$26.5**	**$26.8**	**$32.7**	**$39.8**
Other	0.0	0.0	9.5	0.5	0.8	0.1	0.0
TOTAL LIABILITIES	$40.0	$47.0	$37.5	$27.0	$27.6	$32.8	$43.8
FUND EQUITY	**$ (9.2)**	**$(12.0)**	**$ 1.8**	**$ 5.5**	**$ 0.8**	**$ 0.4**	**$ (6.9)**
PERCENTAGE FUNDED*	77%	74%	106%	121%	103%	101%	83%

* Net assets available to fund liability for self-insurance

NOTE: On December 8, 1993, the Finance Committee approved a Finance Department recommendation to fund an estimated $6.6 million deficit in the Fund. See Appendix G.

The most conservative risk management practice would be to fund in excess of the estimated liability to provide for actual loss experience turning out worse than expected. In practice, though, deficits are common. In fact, our survey of

several self-insured California jurisdictions revealed that San Jose has actually been significantly more conservative than some cities in funding its liability for workers' compensation.

TABLE III

SURVEY OF COMPARABLE CALIFORNIA SELF-INSURANCE PLANS

JURISDICTION	ARE WORKERS' COMPENSATION RESERVES FULLY FUNDED?	ESTIMATED LIABILITY AS OF JUNE 30, 1992
City of Los Angeles	No. Current expenses recognized in the general fund; liability recognized in the general long-term debt account group (GLTDAG).	$191 million
City of Sacramento	Yes.	$22.6 million
City of San Bernardino	No. Goal is to begin fully funding in 1993-94.	$5.8 million
City of San Diego	No. Recognized as an unfunded liability (deficit) in an internal service fund.	$18.8 million
City and County of San Francisco	No. Current expenses recognized in the general fund; liability recognized in the GLTDAG.	$76.2 million
City of San Jose	Yes, with deficit projected in internal service fund.	$32.7 million
City of Oakland	No. Current expenses recognized in the general fund; liability recognized in the GLTDAG.	$24.4 million

It should be noted that by recognizing their workers' compensation liability as general long-term debt, many other jurisdictions are able to avoid the issue of funding the liability. In accordance with generally accepted accounting principles, the general long-term debt of a state or local government is secured by the general credit and revenue-raising powers of the government rather than by current assets or specific fund resources. As a result of this status, claims costs are recognized as expenses in the period in which they are paid, rather than the period in which the accident or illness occurred. The proposed Governmental Accounting Standards Board Statement No. 11 (GASB 11), "Measurement Focus and Basis of Accounting," which is currently on hold, would not allow this treatment. Generally, it would require that governments recognize expenditures when the

underlying transactions take place and attempt to appropriate sufficient amounts to cover future cash outflows arising from current service. Thus, implementation of GASB 11 would leave San Jose in a much better position than many other California jurisdictions.

In our opinion, the City Council should establish a formal policy either to fully or partially fund the City's workers' compensation liability.

The City's Preliminary Estimate Of Program Liability As Of June 30, 1993, Was Approximately $10.9 Million More Than The Workers' Compensation Fund's Cash Reserves

The City has contracted for three actuarial reviews of its Program. The purpose of those reviews was to (1) develop estimates of the City's Program liability for current unpaid claims, (2) provide recommendations for appropriate funding levels to cover those losses, and (3) provide an estimate of expected losses in subsequent years. The City's first workers' compensation actuarial review was completed in April 1989. It estimated the liability as of June 30, 1989, at $22.7 million. A second actuarial review was completed in January 1992. It estimated a $28.8 million liability as of June 30, 1991. Then, in December 1992, the most recent actuarial study estimated the June 30, 1992, liability at $40.7 million. These dramatic increases in incurred and projected workers' compensation costs caused great alarm in the City.[3]

[3] It should be noted that these figures are the actuary's estimate of the expected liability discounted at 6 percent in 1991 and 4 percent in 1992. It should also be noted that the 1991 and 1992 actuarial reports were prepared after the City's Comprehensive Annual Financial Reports (CAFR) for those years, which showed liabilities of $26.8 million for June 30, 1991, and $32.7 million for June 30, 1992 (see Table II).

The City's liability for workers' compensation was $32.7 million on its June 30, 1992, financial statements. This was almost $8 million less than the actuary's latest estimate of the June 30, 1992, liability. In addition, the actuary forecasted higher claims costs for 1992-93. As shown on Table IV, the Administration estimated that the City would need to book an additional $10.5 million liability on its June 30, 1993, financial statements. Of this amount, approximately 87 percent was estimated to be General Fund.

TABLE IV

PRELIMINARY ESTIMATED ADDITIONAL LIABILITY
FOR WORKERS' COMPENSATION AS OF JUNE 30, 1993

ESTIMATED LIABILITY AS OF JUNE 30, 1992		
City's estimated liability for self-insurance as of June 1992 CAFR	$32,742,216	
Actuarially expected liability for self-insurance from December 1992 review[4]	(40,700,000)	
Estimated additional liability as of June 30, 1992		$ (7,957,784)
ESTIMATED ADDITIONAL LIABILITY 1992-93		
Actuarially estimated additional claims liability for 1992-93 (December 1992 Review)	$(13,067,000)	
Estimated claims payments during 1992-93	10,500,000	
Estimated additional liability for 1992-93		$ (2,567,000)
ESTIMATED ADDITIONAL LIABILITY AT JUNE 30, 1993		**$(10,524,784)**

As a result of this additional claims liability, which the Finance Department revised to $11 million, and an operating deficit of $300,000 during 1992-93, the City's preliminary financial statements showed a Fund deficit of approximately $10.9 million as of June 30, 1993. The corresponding preliminary balance sheet showed a total estimated liability for self-insurance of $43,757,784. Table V shows the estimated deficit in the Fund.

[4] Discounted at 4 percent.

TABLE V

ESTIMATED WORKERS' COMPENSATION FUND DEFICIT
FROM PRELIMINARY DRAFT FINANCIAL STATEMENTS
FOR JUNE 30, 1993

FUND EQUITY AS OF JUNE 30, 1992		$ 365,906
FUND ACTIVITY 1992-93		
Employer contributions	$ 9,780,387	
Investment income	1,670,954	
Operating expenses	(1,663,447)	
Payment of claims	(10,229,883)	
Other	141,760	
Net income (loss) before change in liability		$ (300,229)
CHANGE IN ESTIMATED LIABILITY		$(11,015,568)
Net income (loss)		$(11,315,797)
FUND DEFICIT AS OF JUNE 30, 1993		$(10,949,891)

Thus, the City's fully funded policy was not being followed. In March 1993, the Administration presented a series of options for funding workers' compensation to the Finance Committee. Specifically, the Administration proposed that the City

1. Delay funding the June 30, 1993, projected additional liability of $10.5 million until 1995-96;

2. Freeze departmental contribution levels to the Fund at $11.1 million for the next two fiscal years resulting in a projected cash shortfall of $2.4 million for 1993-94 and a projected cash shortfall of $3.9 million in 1994-95; and

3. Begin funding the cumulative $16.8 million shortfall in the Fund in 1995-96 over a four-year period.

The City's Policy To Use An Actuarial Study To Estimate Its Program Liability Is Outdated And Unauthoritative

According to a 1988 Program policy,

> *Risk Management shall be directed by the Risk and Loss Control Manager who reports to the Director of Finance . . . . An annual actuarial study shall be conducted to review claims and establish the amount of the trust fund required to meet all claims and expenses. The amount of reserves so required shall be funded by action of the City Council. To maintain the stability of the fund, the fund shall not be reduced more than 15% per year.*

Although the above policy requires that an annual actuarial study shall be conducted, our review revealed that actuarial reviews have been conducted only sporadically--once in 1989 and twice in 1992. In addition, we determined that this policy was written only to provide internal guidelines for the Workers' Compensation Section and that neither the Administration nor the City Council formally adopted the policy. Furthermore, new governmental accounting standards were issued in November 1989 which obviate the need for an actuarial study (see page 48 for full discussion). Moreover, in July 1991, the Program obtained an on-line claims database which can reliably estimate the Program liability (see page 37 for full discussion). As such, in our opinion, the policy is outdated and unauthoritative.

Recent And Future Actuarial Studies To Estimate The Program Liability Have Been And Will Be Hampered By A Lack Of Sufficient Claims History Information

Actuarial projections are made on the basis of historical trends and estimated future growth factors. They depend on the accuracy and consistency of the information provided to them. If reports of City performance are not consistent and accurate, the actuarial estimates based on those reports may be biased. The December 1992 actuarial study clearly qualified its projections:

> *In this report, we used loss and exposure data provided by City officials. We have not audited this data and are not responsible for its accuracy. The accuracy and*

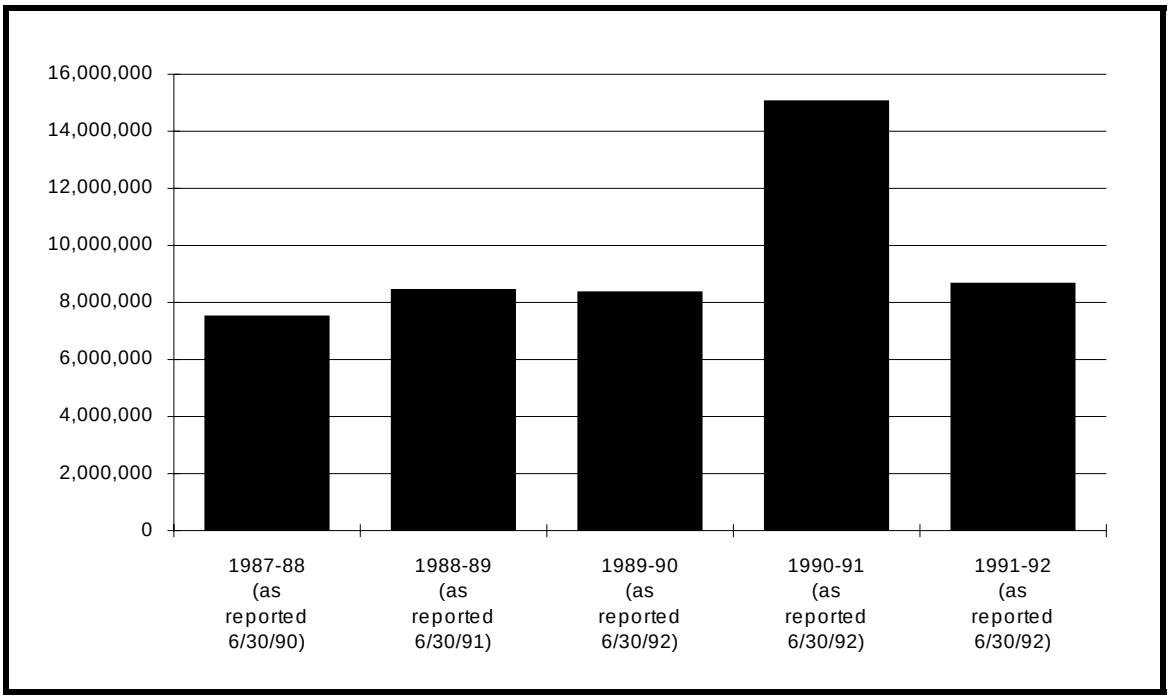
relevance of our conclusions depend on the accuracy and relevance of the underlying data.

Because the claims database cannot recompile data from previous fiscal periods with reliability, the December 1992 review used historical data presented in the annual self-insurer's reports which the Workers' Compensation staff prepared for the state of California's Department of Industrial Relations, Self-Insurance Division. Thus, figures from those reports were the basis for actuarial projections.

Our review revealed that the City dramatically increased its estimate of the ultimate cost for claims reported during 1990-91 on the June 30, 1992, self-insurer's report to the state of California as is shown in Graph I.

GRAPH I

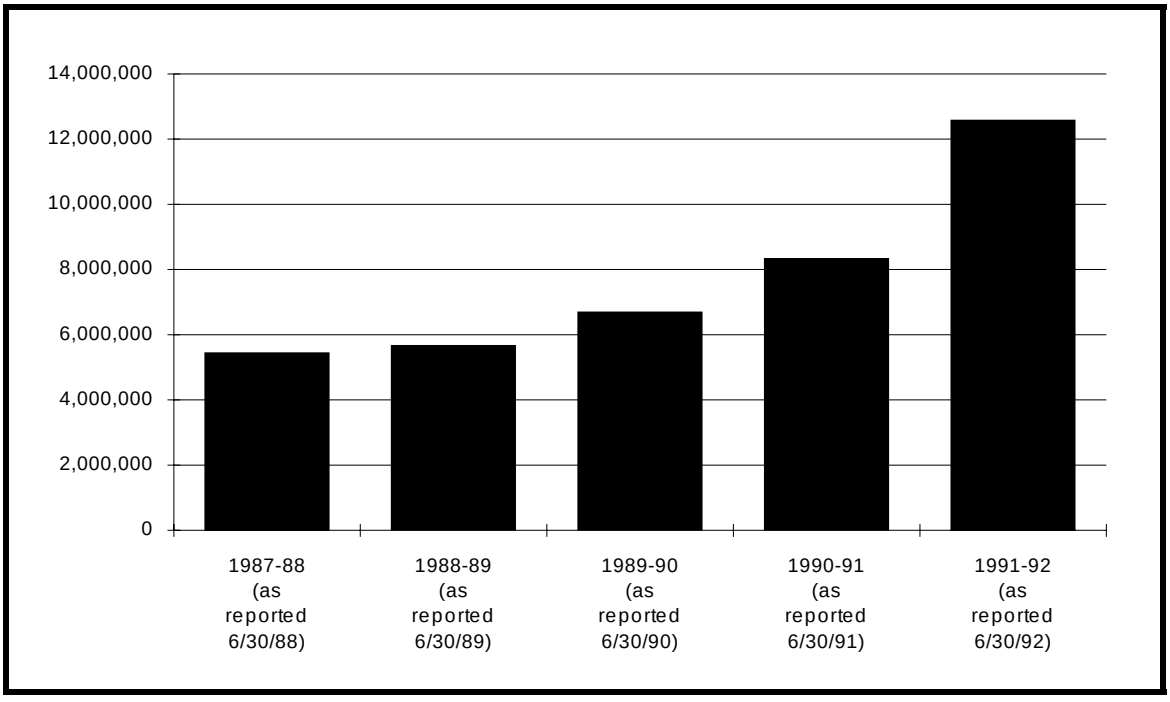
TOTAL ESTIMATED CLAIMS LIABILITY BY REPORT YEAR
AS REPORTED ON STATE SELF-INSURER'S REPORTS



As shown in Graph I, the reported annual claims liability jumped by 80 percent between 1989-90 and 1990-91; however, the number of reported claims increased by only 8 percent. On that report, the City also reported paying out more cash benefits than in any previous year as is shown in Graph II.

GRAPH II

TOTAL BENEFITS PAID BY FISCAL YEAR AS REPORTED ON STATE SELF-INSURER'S REPORTS



According to the actuarial review, these dramatic increases in the City's estimate of its workers' compensation costs had a correspondingly dramatic effect on the actuarial estimate of the City's liability. In fact, the December 1992 actuarial review noted that

> *The most recent actuarial report performed by C&L for the City of San Jose was completed January 6, 1992. In that report, the program's claims liability as of June 30, 1992, was projected to be $39.9 million. In this report, we estimate the liability to be $46.0 million, a 15% difference.*

This increase is due primarily to unusually high loss development over the past year. For several report years, the losses reported to date already exceed our previous estimate of ultimate losses. For example, our previous report estimates the ultimate losses for the 1990-91 report year to be $10.5 million. Yet 1990-91 losses reported to date as of June 30, 1992 total $15.1 million, exceeding the previous estimated ultimate amount.
[Emphasis added.]

The effect was clear in the actuary's estimate of ultimate losses. As of June 1992, the claims database, which tracks outstanding claims reserves on a case-by-case basis, showed total claims reserves for medical and indemnity costs of $31.5 million. However, the December 1992 actuarial review estimated the June 1992 liability for outstanding claims at $41.6 million.[5] The difference lies in the actuary's projection of loss development--that is, the expected growth of current reported losses to their ultimate cost. Thus, as shown in Table VI, the actuary started with the City's reported $31.5 million in estimated claims reserves as of June 20, 1992, and then projected $10.1 million in loss development on those claims--a 32 percent loss development factor.

TABLE VI

DECEMBER 1992 ACTUARIAL ESTIMATE OF THE CITY'S ULTIMATE WORKERS' COMPENSATION LIABILITY FOR OUTSTANDING CLAIMS AS OF JUNE 30, 1992

Outstanding claims reserves (as reported 6/30/92)	$31,487,134	
Expected adverse loss development on outstanding claims	10,105,866	(32%)
	$41,593,000	

[5] The actuary estimated the liability at $41.6 million before discounting. Discounting is a method used to determine the present value of future cash payments that takes into consideration the time value of money. Discounting $41.6 million at 4 percent yields a $40.7 million liability.

As is shown in Table VI, the actuaries felt that the $31.5 million in estimated ultimate payouts for known claims as of June 30, 1992, would really cost $41.6 million when all was said and done.

Our review revealed that there are several explanations for the spike year of 1990-91. First, a major workers' compensation reform took effect January 1, 1990, and the December 1992 actuarial review included an adjustment factor for legislative changes. Second, our review revealed that Program usage may have changed. Specifically, during 1990-91, police and fire claims liabilities increased to 82 percent of the City-wide total (although as a percentage of all claims filed, they held even).

However, our review also revealed multi-million dollar misstatements in the information which the City reported to the actuary and to the state. Specifically, three errors contributed to the reported spike in 1990-91 claims liabilities and the dramatic loss development which was reported on those claims.

First, we found $3.1 million of prior years' claims that were mistakenly reported as 1990-91 claims. Our review revealed that 73 claims[6] from prior years were entered as 1990-91 report year claims during the computer conversion process. As a result, the claims liability total for the 1990-91 report year was overstated by $3.1 million on the June 30, 1992, report. Correspondingly, report years 1975-76 through 1989-90 were understated; however, because the errors

---

[6] We provided a listing of these 73 claims to the Workers' Compensation Manager, and those errors have been corrected in the claims database. We reviewed claims listings to verify that the same misclassification error did not happen to 1991-92 claims. In addition, we compared summary data for previous years to assure ourselves that 1990-91 was the only year in which this occurred. Database information will be correct as of the date corrections are made. However, there appear to be lingering problems regarding historical data. As such, any actuarial study based on that data will be flawed to the extent historical information is unavailable.

were spread out over many years, the largest misclassification for any one report year other than 1990-91 was $600,000.

Second, $1.3 million in incurred costs[7] for 1990-91 report year claims were not reported until June 1992. As of June 30, 1991, a block of 218 claims reported in the last two months of 1990-91 showed no incurred costs. As of June 30, 1992, this same block of claims showed incurred costs of $1.3 million. This delay in data entry occurred because of backlogs during the computer conversion in the summer of 1991. Special Payment Demands (SPD) were generated to pay bills during that period, but the information regarding those payments was not entered into the new computer system until July 1991. Thus, June 1991 estimates of the cost of those claims were understated. As a result, the June 1992 self-insurer's report showed an inflated rate of loss development when compared to the June 1991 report.

Third, report year 1990-91 claims showed $182,000 in negative reserve amounts as of June 1991. The Workers' Compensation Manager corrected the problem by June 1992. Accordingly, claims reserves were understated as of June 30, 1991, and showed an inflated rate of loss development in the subsequent year.

As was noted in Graph II, the June 1992 self-insurer's report also showed dramatic increases in total cash benefits paid during the fiscal year. Our review revealed two reasons why these figures were also unreliable.

First, 1991-92 cash claims payments were overstated by $978,000. The June 30, 1992, self-insurer's report shows "*total benefits paid during*

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[7] Claims costs, paid or unpaid, for which the City had become liable.

FY 1991-92" of $12.6 million. However, our review of claims database records revealed that $978,000 in payments were incorrectly coded as being paid during 1991-92. Thus, the report actually should have shown $11.6 million in cash benefits paid during that year. The payment dates on these transactions were changed when historical payment balances on claims were reviewed for accuracy. When discrepancies were found, the old transaction was backed out of the system, and the corrected payment amount was entered. However, the payment was mistakenly coded as being paid on the date it was re-entered. This occurred during the data entry blitz after the installation of the new claims database system in July 1991.[8]

Second, reported 1991-92 "*total benefits paid*" on the June 30, 1992, self-insurer's report which the City provided to the actuary, apparently included temporary disability (TD) costs for the first time. According to the City's payroll system, TD costs totaled $1.2 million for the year. Previous years' reports of "*total benefits paid during fiscal year*" apparently did not include TD. While including TD payments was appropriate, the change to include TD benefits for the first time in 1991-92 created an unexplained jump in claims costs.[9]

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[8] There were no errors in payment amounts, only in the dates that the items were paid. Thus, claims files reflect accurate amounts paid. Because of the volume of transactions, we agreed with Program staff that to correct these dates on a payment-by-payment basis is not feasible at this time. Management reports from this time forward will not be affected by the incorrect payment dates.

[9] The confusion over TD payments probably stems from the fact that TD is included in the claims database, but is actually paid from the City's personal service budgets (with a few exceptions).

Several Other Factors Make Historical Data From Previous City-Produced Reports Unreliable For Predicting Future Claims Activity

In addition to the above inaccuracies, our review revealed several other factors which make historical data from previous City-produced reports unreliable in predicting future claims activity. Specifically, according to the American Institute of Certified Public Accountants,

> *Changes in the insurance company's claims processing system may invalidate the historical data used to develop and evaluate loss reserves. Types of changes that may have this result include . . .*
>
> - *Changes in settlement patterns, such as slowing down the payment of claims to increase the holding period of investable assets or speeding up the payment of claims to decrease the effects of inflation.*
> - *Changes in case reserving methodologies, either explicit or implicit, such as a change from estimating case basis reserves on an ultimate cost basis to estimating case-basis reserves on a current cost basis.*
> - *Changes in computerized information systems that result in faster or slower recognition and payment of claims.*

Our review of the Program revealed evidence of each of these factors including a new computerized information system, new staff direction on closing claims, and changes in reserve levels for open claims. According to the actuary, they not only need accurate information, but also consistent information in order to trend loss development. Inconsistent data makes it difficult for actuaries to identify and interpret claims reporting and payment trends.

Furthermore, there has been new staff direction on closing claims. Beginning in 1991, Program staff began to aggressively close claims. Allowing cases to remain open unnecessarily increases adjuster caseload and also increases the likelihood of higher claims costs. Thus, the new Workers' Compensation Manager directed adjusters to close at least one file for every file they opened. Under this policy, claims costs are recognized sooner and excess reserves are

released sooner. This type of change in claims settlement patterns makes the City's historic trends less reliable in predicting future activity.

Moreover, claims reserving practices have changed dramatically in the past several years. First, in 1990, the previous Workers' Compensation Manager, responding to a 1989 actuarial report which stated that the City had over reserved on claims, directed adjusters to lower reserves on open claims. In June 1991, the new Workers' Compensation Manager examined the City's open claims reserves and found them insufficient. He directed adjusters to raise claim reserve levels. This had, for example, a dramatic effect on the block of claims reported during 1990-91. Individual case reserves for those claims reported during 1990-91 averaged $3,400 per open claim as of June 1991 but were increased to an average of $13,600 per claim as of June 1992. Second, standard reserves for medical-only claims were increased. In June 1991, the automatic case reserves on medical-only claims were $500 per claim. By June 1992, the standard practice was to assign $2,000 in reserves to each claim. With approximately 850 medical-only claims per report year, this could account for up to $1.3 million in increased claim reserves.

In our opinion, all of the above items have and will impair any actuarial studies to estimate the City's Program liability.

Finally, it should be noted that legal and other allocated loss adjustment expenses were not included in the reports the actuary used. Legal and other expenses, which are directly attributable to individual claims, cost the program approximately $468,000 in 1991-92 and represent an estimated $2.2 million in claims reserves. Apparently, the actuary incorrectly assumed these items were included in the reports which they reviewed.

Subsequent Events Reduced The City's Program Liability As Of June 30, 1993, By $4 Million

In December 1993, through the cooperative efforts of the City Auditor's Office, the City Administration, and KPMG Peat Marwick, the City was able to reduce its June 30, 1993, financial statement liability for workers' compensation from $43.8 million to $39.8 million--a reduction of $4 million.[10]

It should be noted that although the June 30, 1993, adjustments reduced the City's liability from an expected $43.8 million to $39.8 million, the resulting liability still represents

- A $7.1 million (22 percent) increase over the June 30, 1992, liability of $32.7 million and
- A $13 million (49 percent) increase over the June 30, 1991, liability of $26.8 million.

There were two components to the adjustment. The first component of the adjustment was a $2-million reduction in the liability because of increasing the assumed discount rate from 4 to 5.5 percent when calculating the present value of the liability. This increase is due to the expected increase in the rate of return as a result of separately investing Workers' Compensation Fund reserves at longer maturities than would be allowed under the City's investment policies for pooled investments. In its memorandum to the Finance Committee of December 6, 1993, the Finance Department estimates that by extending maturities on Workers' Compensation Fund reserves to a maximum of ten years for any one investment and a maximum average maturity of eight years for the portfolio, it may

[10] See Appendix F.

be able to achieve yields from 5.44 to 7.31 percent depending on different economic scenarios. The adjustment is explained in greater detail in *An Audit Of The City Of San Jose's Investment Of Workers' Compensation Program Fund Reserves* which was issued in December 1993.

The second component of the adjustment was a $2-million reduction in the estimated liability for incurred but not reported (IBNR) workers' compensation claims because the City's claims reporting history is better than expected. The December 1992 actuarial review estimated the ultimate cost of IBNR claims as of June 30, 1993, at $2,991,056. This estimate was based on the assumption that, in a typical city, 87 percent of claims would be filed within the first year after an accident, 11 percent in the second year, and the remaining 2 percent thereafter. However, our review revealed that during the last two years nearly 97 percent of San Jose's claims were filed in the year in which the accident occurred, only 2 percent in the second year, and only 1 percent thereafter. We recalculated the IBNR allowance to reflect this change. The resulting allowance is $778,894 (6.85 percent of the last year's incurred costs). These calculations are included in detail in Appendix C.

It should be noted that the City's recent IBNR experience is consistent with legislative changes which became effective on January 1, 1990. These changes stipulate that employees must receive a claim form within 24 hours of work-related illness or injury, and they also increase the penalties for late payments. To ensure compliance with the new law, the City's Workers' Compensation Manager initiated a policy to set up all claims within five days of receipt in the Program. As a result, the timeliness of claims reporting and processing has improved.

Several Other California Cities Use Their Workers' Compensation Claims Databases To Estimate Their Program Liabilities

We surveyed other California cities to determine whether they were valuing their workers' compensation liability based on an actuarial study or a claim-by-claim review. Survey results showed that 92 percent of the cities surveyed had claims databases. In addition, 33 percent of those with claims databases used a claim-by-claim review instead of an actuarial study to estimate their workers' compensation liability. Furthermore, the two largest cities in the state, Los Angeles and San Diego, use a claim-by-claim method rather than an actuarial review. Finally, the cities of Oakland and Glendale have the same claims database system as San Jose and use it to estimate their liabilities.

Table VII summarizes our survey results.

TABLE VII

SURVEY OF CLAIMS DATABASE USAGE AND VALUATION METHODS IN VARIOUS CALIFORNIA CITIES

City	Database Usage	Valuation Method
Anaheim	Database	Actuarial review
Fresno	Database*	Actuarial review
Glendale	Database*	Claim-by-claim
Long Beach	Database	Actuarial review
Los Angeles	Database	Claim-by-claim
Modesto	Database*	Actuarial review
Oakland	Database*	Claim-by-claim
Riverside	Database*	Actuarial review
Sacramento	Manual	Actuarial review
San Bernardino	Database	Actuarial review
San Diego	Database	Claim-by-claim
San Francisco	Database	Actuarial review
San Jose	Database*	Actuarial review
Santa Ana	Database	Actuarial review

* These jurisdictions use the same claims management database as San Jose.

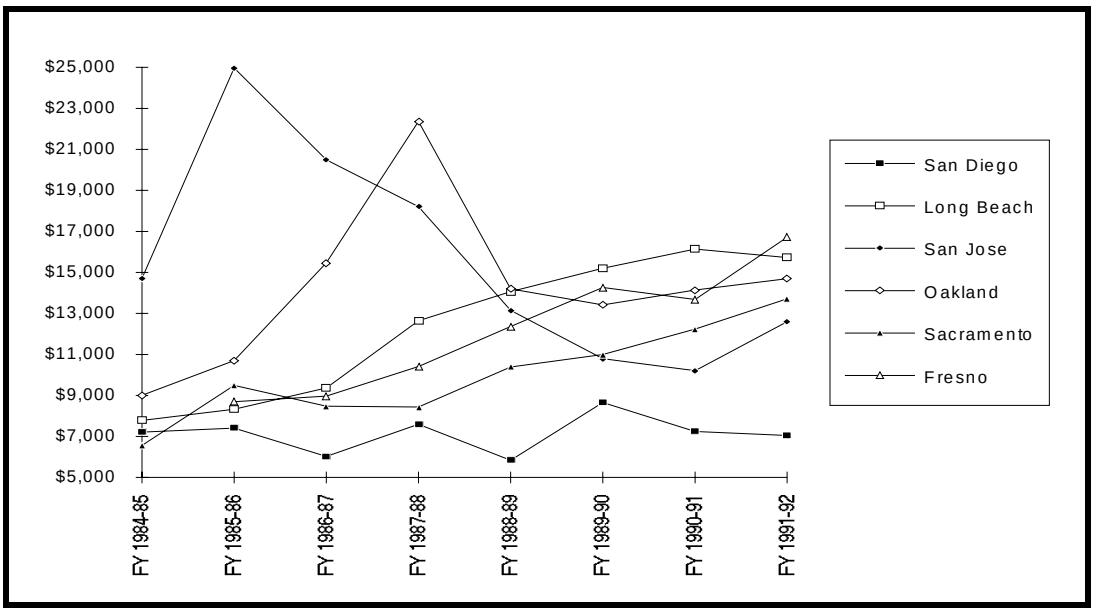
San Jose's Average Claims Liability Is In Line With Other California Cities

Our review revealed that San Jose's average liability amount per open claim is now comparable to other California cities. According to interviews with the Finance Department, at one time the City's adjusters estimated claims reserves on a worst case basis. As Graph III shows, San Jose's estimated liability per open claim was higher than San Diego, Long Beach, Oakland, Sacramento, and Fresno in 1984-85, 1985-86, and 1986-87. The estimated liability per open claim hit a high of $24,971 in 1985-86. Subsequently, adjusters were instructed to reserve at lower levels. By 1990-91, the estimated liability in San Jose had dropped to $10,209 per open claim. Finally, in 1991 adjusters were instructed to increase claims reserve levels. As of 1991-92, San Jose's estimated liability per open claim ($12,600) was

mid-range of the other five cities we reviewed. Fresno was the highest at $16,700 per claim. San Diego was lowest at $7,049 per claim.

GRAPH III

COMPARISON OF ESTIMATED LIABILITY
PER OPEN CLAIM IN SIX CALIFORNIA CITIES



The City's New Computerized Claims Database
Is Now Reliable Enough To Obviate The Need
For Actuarial Studies To Estimate The City's Program Liability

Workers' compensation claims handling was a manual process when the City first self-insured for workers' compensation in 1974. In 1985, records for open claims were entered into a Wang system; historical information on closed claims (that is, prior to 1985) was not entered into the system. Then, in 1989, claims records were transferred to a PC-based system. The PC-based system did not have sufficient record capacity, and, as a result, closed claims were periodically purged to make room for new claims. Finally, in July 1991, the Program obtained an on-line workers' compensation claims database system called the David System.

Programmers used a conversion process to download the PC-based claims information into the new system.

Program management informed us that there were serious problems with the conversion, and the process took several months. However, after the data conversion, staff undertook three major "cleanups" of the database by comparing file documentation to on-line computer information and making corrections to the database where necessary. Examples of the type of claims information that needed to be corrected were: (1) type of claim, (2) type of injury, (3) employee classification code, and (4) level of reserves.[11]

The information in the claims database is currently being used in several ways. First, to provide current and accurate information on claims status and payments so claims can be effectively managed by adjusters. Second, to compile information for reporting purposes, including the annual self-insurer's report. Third, to produce management and exception reports.

In June 1993, there were a total of 3,198 open claims in the database with injury dates stretching back to 1957 and with outstanding reserves of $38 million. Table VIII shows the open claims reserves as of June 1993 by year of injury.

---

[11] During the course of the audit, three extraordinary errors in reserves for legal expenses were detected in the database: a $19.3 million reserve on one claim that was meant to be $13,000; a $177.5 million reserve on a claim that should have been $10,000; and a $70 million reserve on a closed claim that should have been zero. All three errors originated at the time of the summer 1991 computer conversion. In each case, an error had been discovered and staff had attempted to correct it, but because of the size of the number, the system truncated the number and the correction did not take. The resulting, cumulative errors went undetected because legal reserves had not appeared on management reports. After we brought these errors to their attention, Program staff reversed the erroneous entries with the help of the software manufacturer and now includes legal reserves in management reports. Errors of this magnitude are no longer possible because of authorization limits now in place.

TABLE VIII

ESTIMATED FUTURE COSTS OF OPEN WORKERS' COMPENSATION CLAIMS IN THE CLAIMS DATABASE AS OF JUNE 30, 1993, BY DATE OF INJURY

Injury Year	Number Of Open Claims	Open Reserves
1957-58	1	$1,290
1968-69	1	1,793
1970-71	1	27,652
1972-73	1	3,352
1974-75	8	92,787
1975-76	18	188,406
1976-77	21	231,094
1977-78	17	52,380
1978-79	23	363,183
1979-80	25	399,320
1980-81	23	707,621
1981-82	31	264,297
1982-83	41	534,949
1983-84	74	1,035,732
1984-85	81	999,503
1985-86	107	1,351,017
1986-87	138	1,883,134
1987-88	164	1,964,742
1988-89	249	2,787,050
1989-90	287	3,238,225
1990-91	395	6,345,096
1991-92	493	6,914,684
1992-93	999	8,657,295
TOTAL OPEN CLAIMS	3,198	38,044,602

NOTE: Injuries prior to 1974 were insured by the State Compensation Insurance Fund but are administered by the City's Program. Expenses are reimbursed by the State Fund.

The computerized claims database facilitates recordkeeping. It includes:

- A reserving feature for adjusters to estimate the expected cost of each claim;
- A payment system which will not allow additional payments on a claim without sufficient reserves;

- A reporting feature which summarizes claims information by date of injury or date of report, type of claim, and paid and reserve amounts; and
- A "diary" system which flags claims needing adjuster review.

Initial reserves are established at the time a claim is filed. The standard reserve for a medical-only case is $2,000. All other case reserves are based on the best judgment of adjusters using known factors about the case including: type of injury, physical requirements of job, age of employee, physician, prior claims history, and the departments' ability to provide short-term, modified duty. Reserves are based on known or probable factors. Other open cases for the employee are reviewed, and the reserves are coordinated on all cases.

Estimating ultimate workers' compensation claims costs is a difficult and uncertain process. In addition to complicated human, medical, and legal factors, workers' compensation claims are commonly referred to as long-tailed claims because of the extended time that may be required before claims are ultimately settled. It is generally more difficult to estimate loss reserves for long-tailed claims because of the long period that elapses between the occurrence of a claim and its final disposition.

Adjusters are required to review reserve levels whenever needed, or at least once every six months when a case is on diary. Early in the process, adjusters estimate case reserves based on preliminary data which may be incomplete. Thus, the original estimate may differ from the ultimate settlement amount. However, as more information becomes available about the claim, the accuracy of reserve estimates increases.

The Workers' Compensation Manager has directed adjusters to establish reserves in the computer system based on the adjusters' estimate of the ultimate cost

of an individual claim. This is not to say that the difference between expected and actual may not be significant for any particular case. For example, despite an adjuster's best estimate and case management, a claim may "blow up" into a major medical expense or, conversely, may be resolved for less than expected. People do "get worse" or "get better" unexpectedly. However, by reserving individual claims conservatively and encouraging adjusters to set aside reserves based on their best estimate of the ultimate cost of a claim, the management of the Program has established reserving policies such that excesses and deficiencies of reserves will, at least partially, offset each other.

Supervisors must approve all reserves or reserve changes which exceed an adjuster's authority before they are coded against a case. The Workers' Compensation Manager has established individual authorization levels based on the adjusters' experience levels. Supervisors are authorized to incur reserves and reserve changes of up to $75,000 per claim; adjusters are authorized to incur reserves of up to $30,000 per claim and reserve changes of up to $50,000. Reserves above those amounts must be approved by the Workers' Compensation Manager.

Adjustments Are Made As Losses Become Estimable

Loss development is the increase in the aggregate cost of claims due to additional information being received. The result is that the estimated final cost for a block of claims is often revised upward over time. Our review revealed that adjusters are making the necessary changes to reserve levels as they receive new information about claims and the losses become estimable. For example, as shown in Table IX, during 1992-93, adjusters increased estimates of the ultimate cost of prior years' claims by $6.3 million.

TABLE IX

ESTIMATION OF LOSS DEVELOPMENT ON CLAIMS FROM ALL REPORT YEARS DURING FISCAL YEAR ENDING JUNE 30, 1993

Claims reserves as of 6/30/92	31,370,065
1992-93 claims reported YTD	11,370,713
YTD claims payments (all report years)	(10,985,711)
	31,755,067
Estimated loss development on prior years' claims	**6,289,536**
Claims reserves as of 6/30/93	$38,044,603
Loss development as a percentage of 6/30/92 claims reserves	20%

However, our review of current database reports suggests that the rate of growth in prior years' losses is slowing down dramatically. Specifically, during the first trimester of 1993-94, adjusters added a total of $1.5 million in estimated costs to prior years' claims--significantly below the 1992-93 rate of growth. This is consistent with anecdotal evidence that the City's claims reserving practices were dramatically tightened and are now stabilizing.

Our analysis also showed that, during the first trimester of 1993-94, adjusters added $1.1 million in estimated costs to reserves for claims filed during 1992-93 but only $0.4 million to the estimated total cost of all prior years' claims. Table X shows the changes in the total estimated cost of claims by report year during this period.

TABLE X

NET CHANGE TO ESTIMATED ULTIMATE COST OF CLAIMS BY REPORT YEAR ENTERED IN THE DATABASE BY ADJUSTERS BETWEEN JULY 1, 1993, AND OCTOBER 31, 1993

Report Year	Net Change To Estimated Ultimate Cost Of Claims
Prior years	$(138,297)
1987-88	(46,664)
1988-89	(30,430)
1989-90	(42,376)
1990-91	116,661
1991-92	500,440
1992-23	1,094,181
Subtotal	$1,453,515

In addition, our analysis revealed that only 11 claims accounted for $750,000 of the $1.1 million in claims reserve increments for report year 1992-93 as of October 31, 1993. Upon further review, we determined that in each case a specific and unforeseen event triggered the re-estimation of costs. For example:

- In mid-August, an employee had complications after what was thought to be routine surgery and was in the hospital for 15 days at an estimated cost of $2,000 per day. Because this was the third surgery, the employee may have permanent work restrictions. As soon as the adjuster had this information, she added $52,000 to claims reserves for this case.

- At the end of July, a physician imposed permanent work restrictions on an employee who had been working modified duty for several months. Until that time, the adjuster had expected the employee to return to work. After additional tests during the month of August 1993, the employee had back surgery. As soon as the adjuster knew of this situation, she added claims reserves for this case.

- An employee had neck and back pain from a minor office accident. Due to the employee's history of medical problems, the adjuster reserved

> $20,000 for this claim. However, in July the employee's physician recommended major back surgery. Once informed of the physician's recommendation, the adjuster added $43,000 in reserves for this case.

Finally, we reviewed cases closed between July 1, 1993, and October 31, 1993. During that period, adjusters closed 299 claims which were reported during 1992-93. For those 299 claims, reserves were $922,000 more than the ultimate cost of the claims. In our opinion, this evidences that adjusters' estimates are more than reasonable and reserving practices appear to be sound.

As these cases demonstrate, adjusters re-estimate the total cost of a claim as soon as an event occurs that changes the nature of the claim. Depending on the timing of these events, additional costs may be accrued on a known claim after the end of the fiscal year. In our opinion, this is in accordance with the precepts of GASB Statement No. 10 (GASB 10), "Accounting and Financial Reporting for Risk Financing and Related Insurance Issues," which require that

> *. . . state and local government entities should report an estimated loss from a claim as an expenditure/expense and as a liability if <u>both</u> of these conditions are met:*
>
> *a. Information available before the financial statements are issued indicates that it is probable that an asset had been impaired or a liability had been incurred at the date of the financial statements. . . .*
>
> *b. The amount of loss can be reasonably estimated.*

Sample Of Claims Filed Between January 1990 And December 1992 And Review Of Largest Open Claims Revealed That Database Claims Reserves Are Reliable

To test the accuracy and reliability of claims database information, we statistically sampled 79 of 4,858 claims filed between January 1, 1990, and December 31, 1992. The audit objective was to assess the

- Effectiveness of internal controls;
- Reasonableness and completeness of documentation in the files;
- Compliance with state of California documentation and timeliness standards;
- Accuracy of information in the claims database; and
- Adequacy of claims reserves.

Our review of claims files revealed that

- Medical payments made on these claims were appropriate, documented, and authorized when required;[12]
- There were no outstanding reserves on closed claims; and
- Case reserves on these claims appeared appropriate, were authorized, and conformed to established procedures and accepted practices.

It should be noted that minor errors in outstanding reserve amounts were found in only 2 of 30 open claims (7 percent) reviewed; no pattern of deficiencies was indicated in this area. The average error was only $88 per claim for

[12] Documentation in the majority of the files we reviewed was reasonable and complete. Only 18 minor discrepancies were found between hard copy information in the files and the database. Furthermore, the state mandates time requirements for processing claims and payments, and adjusters must self-impose penalties for late payments. According to Program management, 18,441 medical bills were processed in 1991-92, of which only 100 were late.

outstanding reserves in this sample; this would extrapolate to $275,000 for 3,126 open claims in the population.

In addition, based on the results of our sample, adjusters seem to be making reasonable estimates for total claims costs over the life of the claims and reserving appropriately. Of 43 closed claims in our sample, 39 settled for equal to or less than the initially reserved amount while only four closed for more than the initially reserved amount. Thus, our sample revealed only 9 percent of closed cases where claims costs were ultimately more than estimated and 91 percent where costs were less than or equal to originally estimated reserve amounts.

We also reviewed all open claims with reserves over $70,000 as of June 30, 1993--a total of 70 claims. Open database reserves on these claims were $8.1 million, or 21 percent of the total database reserves of $38 million. We found only six cases where reserves in the computer differed from the reserve worksheet in the file. In every case, the computer indicated higher reserves than the reserve worksheet; the total was only $181,000 out of $8.1 million. There were no cases where reserve increases approved by the adjuster were not entered into the claims database.

In addition, trend analysis on claims in the database confirmed that

- Claims payments and reserves in the database are behaving normally; that is, heaviest loss development occurs in the second year as more information is available and then tapers off over the life of the claim;
- Loss development in the claims database is a clear indicator that adjusters are revising reserve amounts as additional information on claims becomes available; and
- Our reserve levels per open claim are in the middle range when compared with other large California cities.

Our review of a sample of claims files confirmed that adjusters now set a minimum $2,000 reserve for each medical-only claim. They appear to reserve a reasonable estimate of the ultimate cost of a claim based on information then available. For example, our file review yielded several precautionary reserves established for possible permanent disability cases. In addition, although reserves are reviewed whenever significant events occur (for example, proposed surgery, diagnosis of additional medical problems, or settlement of a case), our interviews with adjusters revealed they are conscientious about not step reserving--that is, ratcheting up reserves after each new piece of information. Furthermore, adjusters talk to each other about cases, sharing information with each other regarding loss development and reserve levels. Moreover, our interviews confirmed management's expectation that "*reserves on a claim should reflect the ultimate probable value of a claim*."

It should be noted that the City's external auditors have reviewed our sampling methodology and resultant conclusions regarding the reliability of the information in the claims database. According to the external auditors, they are satisfied with our methodology and expressed that our conclusions regarding the reliability of the information in the claims database appear to be well founded and adequately documented.

Reliance On Its Program Claims Database And Early Implementation Of A Recent Governmental Accounting Standards Board Pronouncement Could Have Reduced The City's Financial Statement Liability By An Additional $4.6 Million As Of June 30, 1993

Our review revealed that GASB 10, which was issued in November 1989 and becomes effective in 1994-95,[13] requires financial statement recognition of probable liabilities only if they can be reasonably estimated. GASB 10 specifically prescribes that

> *. . . if a claim is asserted and the probable loss is reasonably estimable, the expenditure/expense and liability should be recognized in the financial statements . . . .*
>
> *Claims liabilities, including IBNR, should be based on the estimated ultimate cost of settling the claims (including the effects of inflation and other societal and economic factors), using past experience adjusted for current trends, and any other factors that would modify past experience. Expenditures/expenses and liabilities may be estimated through a case-by-case review of all claims, the application of historical experience to the outstanding claims, or a combination of these methods.* [Emphasis added.]

In other words, the liability may be estimated by actuarial methods, by a case-by-case review, or by some combination of the two methods. Actuarial methods take the "macro" view--they trend historical data against current estimated losses to project the entity's ultimate claims liability. On the other hand, a case-by-case analysis is a "micro" approach whereby qualified and experienced adjusters estimate the ultimate costs of individual claims; the liability is the sum of the individual claims reserves. The claims database, which was established by the City in July 1991, provides such a case-by-case estimate of outstanding claims costs.[14]

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[13] Early implementation is encouraged.

[14] It should be noted that the claims database includes records of TD payments and reserves on a claim-by-claim basis. Thus, estimated TD is included in the City's statement of its Program liability. However, the City also offers

It should be noted that GASB 10 requires the application of different principles if an entity is transferring or accepting risk. These principles do not apply to the City, which is self-insured and accounts for its Program liability in an internal service fund. The City has neither transferred its risk to another entity nor accepted risk from another entity. Thus, if losses exceed initial estimates, the City will assess itself an additional amount to reimburse the Fund for those losses either by increasing payroll rates or initiating a fund transfer. On the other hand, if losses are below initial estimates, the City may choose to reduce payroll rates or transfer money out of the Fund.

GASB 10 requires recognition of incurred but not reported (IBNR) claims:

> *There are also situations in which incidents occur before the balance sheet date but claims are not reported or asserted when the financial statements are prepared. If an incurred but not reported (IBNR) loss can be reasonably estimated and it is probable that a claim will be asserted, the expenditure/expense and liability should be recognized.*

In addition, GASB 10 allows the practice of discounting whereby the City discounts its expected liability using a rate based on the City's portfolio yields. According to GASB 10,

> *The practice of presenting claims liabilities at the discounted present value of estimated future cash payments (discounting) is neither mandated nor prohibited.*

Furthermore, the Governmental Accounting Standards Board's Guide to Implementation of GASB Statement 10 on Accounting and Financial Reporting for Risk Financing and Related Insurance Issues, which was released in December

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its employees a disability leave supplement which is not accrued in the database. Both types of payments are normally made out of departmental personal service budgets, not the Workers' Compensation Fund.

1993, requires the City to accrue for supplemental workers' compensation benefits. Specifically,

> *Q--Does Statement 10 apply to supplemental workers' compensation benefits?*
>
> *A--. . . To the extent that an entity has claims, either reported or incurred but not reported (IBNR), for which risk has not been transferred, it should accrue a liability or disclose a contingency . . .*

Disability leave supplement (DLS) is a supplemental workers' compensation benefit the City provides to its employees. The City pays approximately $2 million per year for DLS. Although the City has not accrued for DLS in its financial statements, it will be required to do so under GASB 10. We estimate that if the City had accrued for DLS in its June 30, 1993, financial statements, the amount would have been approximately $1.1 million (54 percent of annual expense). Our calculation of DLS is included in Appendix D.

However, on the positive side, our review revealed that the City unnecessarily included $1.8 million in administrative costs in its June 30, 1993, workers' compensation financial statement liability. In other words, while the City is required to accrue for employee benefits, it is not required to do so for administrative costs. Specifically, according to the GASB 10 implementation guide,

> *Q--Should the claims liabilities calculated in accordance with . . . Statement 10 include costs related to the claims?*
>
> *A--No. Unlike for public entity risk pools, there is no requirement in Statement 10 to accrue these expenses with related claims.*

Finally, GASB 10 allows the City to use either an actuarial study or a claim-by-claim estimation of its workers' compensation liability. According to the GASB 10 implementation guide, ". . . *the help of an actuary may be desirable, although the GASB*

does not require that an actuary's services be used." As such, the City can and should rely on its claims database to estimate its liability for workers' compensation claims.

Using the City's current actuarially based methodology, the City estimated that its liability for workers' compensation was approximately $43.7 million as of June 30, 1993. Using the database method, including allowances for other factors required by GASB 10, we estimated that the liability was approximately $35.1 million--a net difference of $8.6 million.

Table XI compares the difference between recognizing the liability based on a case-by-case review in the database versus using the actuarial estimate.

TABLE XI

ESTIMATED LIABILITY FOR WORKERS' COMPENSATION
AS OF JUNE 30, 1993

ESTIMATED LIABILITY FROM PRELIMINARY FINANCIAL STATEMENTS[15]		$43,757,784
ESTIMATED LIABILITY BASED ON DATABASE CLAIMS RESERVES		
Database claims reserves as of June 30, 1993[16]	$38,044,603	
Allowance for IBNR claims[17]	778,894	
Allowance for DLS payments[18]	1,115,927	
Allowance for discounting at 5.5%[19]	(4,794,435)	
ESTIMATED LIABILITY		$35,144,989
DIFFERENCE BETWEEN SCENARIOS		$ 8,612,795

As was noted earlier on page 33, the City reduced its estimated June 30, 1993, Program liability of $43,757,784 by $4 million to $39,757,784. However, in our opinion, the City could have reduced its June 30, 1993, Program liability by an additional $4.6 million if it had (1) relied on its Program claims database to estimate the expected ultimate cost of outstanding claims instead of relying on the December 1992 actuarial estimate and (2) implemented all of the provisions of GASB 10 as of June 30, 1993.

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[15] The estimated liability from the preliminary financial statements was based on actuarial projections of claims reserves (discounted at 4 percent), IBNR, and ULAE.

[16] The adjusters' estimates of the ultimate cost of each reported claim less the amount paid to date on those claims.

[17] These calculations are included in **Appendix C**.

[18] Refer to **Appendix D**.

[19] The December 1992 actuarial review estimated that 15 percent of payments are applied to claims in the fist payment year after the accident, that 15 percent are applied in the second year, 14 percent in the third year, and so on. However, our review revealed that during 1992-93, 23 percent of payments were applied to claims in the first payment year, 26 percent in the second year, and 19 percent in the third year. This is consistent with legislative changes in 1990 mandating more timely payment of claims. Re-estimation of the discount factors is based on current claims payment information in the database. Details are included in **Appendix E**.

It should be noted that the City's external auditors have informed the City Auditor's Office that reliance on the claims database to estimate the City's liability is allowable under GASB 10. Further, the use of the claims database would not result in their issuing an adverse or qualified opinion on the City's financial statements provided that the criteria in GASB 10 are followed. The external auditors informed the City Auditor's Office that they have several other municipal clients who similarly use a claims database to estimate their workers' compensation liability.

Further, as was noted on page 35, several other California cities use their claims databases to estimate their workers' compensation liability, and all of these cities have received unqualified financial statement opinions from their international external auditing firms. According to the Workers' Compensation Manager in San Diego, the claims database methodology we are recommending works if claims reserves are posted correctly and claims administrators are competent. In our opinion, based upon months of detailed reviews of claims reserves and the City's adjusters having 128 years of experience managing claims and/or estimating claims costs, San Jose satisfies both of these criteria.

Administrative And Auditing Procedures Are Needed
To Maintain The Integrity Of The Claims Database

If the Council decides to rely on the claims database for its estimation, then written policies and procedures for maintaining database claims reserves will be extremely important to ensure the accuracy and objectivity of reserving practices. In addition, conducting an annual audit of the workers' compensation database claims reserves and obtaining the opinion of the City's external auditors at year-end, will give the City further assurance that its estimation is reasonable.

The Program's procedures manual should be updated to reflect current practices. A current procedures manual is necessary to ensure

- Consistent and efficient administration of claims;
- Consistent and reliable database information;
- Accurate state self-insurer's reports; and
- Reliable management and exception reports.

In addition, written policies regarding claims reserving practices should be prepared to ensure that management's direction to adjusters is clear. However, the Program's procedures manual has not been completely revised since 1989. Some, but not all, written procedures have been revised to address the computerized claims database that was installed in 1991. In addition, the procedures manual has not been updated to reflect current reserving practices (e.g., establishing precautionary reserves for permanent disability claims and standard reserves of $2,000 for each medical-only claim). The Workers' Compensation Manager has started an update of the manual. It is currently scheduled for completion in the winter of 1994.

Regular reserve analysis on open claims is an important claims management tool. By reviewing each claim file, it becomes possible to identify those cases with unusual claims activity and to then ensure that cases are reserved at the appropriate level. This ensures that the City's expected losses (which include case reserves) are correctly stated and that management reports are accurate. According to the Governmental Risk Management Manual,

> *Great care should be taken by the risk manager to watch reserving practices at the end of each policy year. At this time, reserves for all open cases should be reviewed inasmuch as . . . claims go into the formula at the reserved amount.*

For this reason, it is necessary that Risk Management include written policies regarding reserving practices in its updated procedures manual to ensure consistent application of those policies in the future. We also noted that the database does not show when an adjuster reviewed the reserves on a particular case unless a reserve change was made. We therefore recommend that adjusters initial and date reserve worksheets to document their periodic reviews. This procedure should also be included in the new procedures manual.

Further, we recommend that the Workers' Compensation Section prepare monthly claims summary reports in a standard, consistent format. Such reports will provide early information on developing trends in the database. In this way, the Workers' Compensation Section can better monitor claims and improve its reserving practices.

In addition, the claims database should be audited annually. The current City Auditor's audit of the City's Workers' Compensation Program contains the elements of a typical claims administration audit. Its scope and methods are comparable to those conducted elsewhere. To ensure the reliability of the claims database for use in managing workers' compensation claims and for estimating the City's liability for workers' compensation claims on its financial statements, the City Council should direct the City Auditor to conduct an annual claims administration audit to ensure accuracy and correctness as part of a quality assurance program regarding the integrity of the workers' compensation claims database.

Finally, the method for calculating year-end accruals for IBNR, DLS, and discount factors should be documented. Documentation of these calculations may be needed during the year-end audit of the City's financial statements.

CONCLUSION

Our review revealed that the December 1992 actuarial review of the City's workers' compensation liability relied on information that was inaccurate. Furthermore, the City's historical claims information cannot reliably predict future losses. However, our review revealed that the workers' compensation claims database does contain a reliable and reasonable estimate of the City's liability. Furthermore, GASB 10 allows for using this type of estimate on the City's financial statements. Accordingly, the City should rely on its claims database, coupled with an allowance for incurred but not reported claims and an allowance for disability leave supplement payments, to estimate its liability for workers' compensation on its financial statements. To ensure the reliability of this estimation, the Workers' Compensation Program's procedures manual should be completed and the City Auditor should annually audit the claims database.

RECOMMENDATIONS

We recommend that the Finance Department:

Recommendation #1:

Annually calculate the estimated liability for workers' compensation using current information in the workers' compensation claims database. The estimate should include:

- Total reserves net of administrative costs on all claims in the database at year end;
- An allowance for incurred but not reported claims (IBNR) based on recent reporting patterns;
- An allowance for disability leave supplement (DLS) payments; and
- An allowance for discounting the liability based on expected investment yields and recent payment patterns.

(Priority 1)

Recommendation #2:

Prepare monthly claims summary reports in a standard, consistent format to provide early information on developing trends in the database, better monitor claims, and improve reserving practices. (Priority 3)

Recommendation #3:

Prepare formal written policies and procedures regarding claims reserving practices including:

- Conventions for setting initial claims reserve levels by type of injury and for revising reserve estimates in light of new medical and/or legal information;
- Conventions for establishing precautionary permanent disability reserve amounts;
- Frequency, extent, and documentation of adjusters' reviews of claims reserves;
- Periodic management reports on closed claims to ensure that reserves are properly backed out;
- Periodic management reports on all open claims for review of reserve levels outside a conventional range; and
- Authorization limits and supervisory review of reserves.

(Priority 3)

Recommendation #4:

Prepare written procedures for entering data, producing consistent management reports, ensuring accuracy in the workers' compensation claims database, and reporting claims activity to the state. (Priority 3)

Recommendation #5:

Document the claims database errors which have been corrected as a result of the audit to ensure a clear record of changes to the historical record. Document recent cleanups of the claims database to explain changes in database reports from one period to another. (Priority 3)

Furthermore, we recommend that the City Council:

Recommendation #6:

Establish a City Council policy whether to fully fund the workers' compensation liability. (Priority 3)

Recommendation #7:

Direct the City Auditor to conduct an annual claims administration audit to ensure accuracy and correctness as part of a quality assurance program regarding the integrity of the workers' compensation claims database. (Priority 2)